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Chief Executive Officer

October 9, 2009

To: Supervisor Don Knabe, Chairman
Supervisor Gloria Molina
Supervisor Mark Ridley-Thomas
Supervisor Zev Yaroslavsky
Supervisor Michael D. Antonovich

From: William T Fujioka
Chief Executive Officer

COMMISSION ON THE 21ST CENTURY ECONOMY (ITEM NO. 32, AGENDA OF OCTOBER 13, 2009)

On September 29, 2009 your Board directed this Office to review, analyze, and report back to the Board on the proposals made by the State Commission on the 21st Century Economy (Commission) and their potential impact, if any, on the County's:

- Revenue;
- Operations, including implications on vendors, contractors, and service providers;
- Employees; and
- Business climate, especially as it relates to job creation, attraction, and retention; small business development and sustainability; and imposition, elimination, reduction, or increase of tax expenditures (i.e., tax credits, exclusion, exceptions, etc.) on various sectors.

Background

On July 29, 2009, Governor Schwarzenegger signed Executive Order S-15-09 mandating that the bipartisan Commission re-examine and modernize California's out-of-date revenue laws that contribute to "feast-or-famine" State budget cycles.

The Commission was comprised of 14 members, seven appointed by the Governor and seven appointed by the Legislature.

Applying the principles outlined in Governor Schwarzenegger's Executive Order, the Commission was charged with recommending changes to State and local revenues that would result in a revenue stream that is more stable and reflective of the California economy. The Commission submitted their final report to the Governor and Legislature on September 29, 2009.

The key guiding principals of the Commission were to:

- Establish a 21st century tax structure that fits with the State's 21st century economy;
- Stabilize State revenues and reduce volatility;
- Promote the long-term economic prosperity of the State and its citizens;
- Improve California's ability to successfully compete with other states and nations for jobs and investments;
- Reflect principles of sound tax policy, including simplicity, competitiveness, efficiency, predictability, stability, and ease of compliance and administration; and
- Ensure that tax structure is fair and equitable.

On September 29, 2009, the Governor called a legislative special session and asked lawmakers to approve the package this year.

Summary of the Commission's Recommendations

Sections One and Two represent the recommendations contained in the report, which a majority of the Commissioners endorsed to submit to the Governor and Legislature. It should be noted that five of the Commissioners chose not to endorse the Commission report.

Section One

These recommendations are of a statutory nature, and may become effective upon passage by a majority of the State Legislature and signature by the Governor.

- **Reduce Personal Income Tax (PIT) for every taxpayer** – Reduce the number of tax brackets from six to two. After a three-year phase-in period through 2014, the new PIT tax rate beginning in 2015 would be 2.75 percent for taxable income up to $56,000 for joint filers ($28,000 for single) and 6.5 percent for taxable income above that amount. The Commission states these changes would retain the PIT's progressive nature while reducing income tax rates for all taxpayers. The proposal would reduce the amount of income tax paid by 29 percent.

- **Eliminate the corporation tax and minimum tax** – Eliminate the current 8.84 percent corporate tax and the $800 minimum franchise tax in 2012, the first year of the tax plan.

- **Eliminate the State general purpose sales tax** – Eliminate the current 5 percent State portion of the sales tax, with the exception of the sales tax on gas and diesel fuels which would continue to be dedicated to transportation. Elimination of this portion of the sales tax would be phased in over five years.

- **Establish a new Business Net Receipts Tax (BNRT)** – Establish a BNRT, not to exceed 4 percent, applied broadly to the net receipts of most business transactions. Small businesses with less than $500,000 in gross annual receipts would be exempt from this tax. BNRT would have a much broader base than the sales tax since it would apply not only to goods, but also to services and to sales into the State from businesses located outside the State and, unlike the sales tax, be deductible against Federal taxes. The BNRT would be phased in over five years, starting at 2 percent in 2012.

- **Create an independent tax dispute forum** – This forum would provide taxpayers with a forum for resolving disputes with the State.

Section Two

This recommendation requires a change in the State Constitution or a State ballot initiative in order to be effective.

- **Strengthen the State's Rainy Day Reserve Fund** – Increase the target for the reserve from 5 percent of revenues to 12.5 percent and restrict the State government's ability to use reserve assets so that the reserve is available to help fund services during recessionary periods.

Potential Impact to the County of Los Angeles

The Commission's recommendations and their potential impact to County constituents and operations could be significant. Any transition to a new tax system would require careful oversight and additional analysis of its impact on the County as a whole. Our preliminary analyses of the impacts which the Commission's proposed recommendations could have on the County are discussed below:

Revenue

The Commission recommends implementing the proposed tax changes in 2012. This time frame is intended to give the Legislature time to evaluate the various components of the proposed changes. While the proposed tax changes discussed in the report are revenues directly generated for the State coffers, the impact to counties is unknown and could be significant. It should be pointed out that the proposal may well be revenue neutral in the year it is fully implemented, but it could easily cease to be revenue neutral in subsequent years. Some have raised concerns because the proposal reduces the State's two fastest growing revenues over the last 30 years, Personal Income and Corporation taxes, thereby, leaving the State more reliant on revenue sources that grow more slowly. The ability of this new tax structure to grow along with the State's growth is an important consideration. If it cannot keep pace, future State subventions for County programs and services could be jeopardized

Eliminating the State general purpose sales tax (5 percent) without altering local sales taxes or the sales tax on gasoline would directly lower the amount of sales taxes paid by County residents. In other words, Los Angeles' sales and use tax would be 4.75 percent instead of 9.75 percent after the phasing out of the State general purpose sales tax over five years by reducing it 1 percent point each year.

The report does not address the impact to the County specifically, other than providing a "safety mechanism" that would ensure the transition from the old to the new tax system is revenue neutral, meaning the revenue raised would be the same as would have been raised under current tax law. This would be an important consideration as it would protect departments that have budgets subvened by the State. However, the proposed changes are not without controversy and several entities are already posting dissenting analyses and opinions, challenging the premise that the new tax system would be beneficial to the citizens and economy of California.

Operations

Although the other recommendations do not directly impact the County, the overall effect on the State revenue is unknown. The report implies that the revenue stream for the State would become more reliable and reduce its reliance on volatile revenue sources. However, if these new revenue streams do not generate the revenues needed to sustain the State's needs, the State may still turn to counties for assistance as it has done in the past and currently under Proposition 1A. Impact on vendors, contractors, and service providers is discussed in the Business section below.

County Residents/Employees

As mentioned above, the proposed changes to the PIT would lower State taxes paid across income groups by an average of 29 percent for County residents and employees. The report also recommends a mechanism that would provide taxpayers with a forum for resolving disputes with the State.

The new tax system would eliminate all current income tax deductions and credits except for mortgage interest, property tax, and charitable contribution deductions. It would also impose new taxes on services, such as child care, doctors, and dentists, as well as medicine, food, and utilities. Further analysis is required to determine if the decrease in PIT would be offset by the new taxes and the elimination of current deductions.

While all tax filers would pay lower taxes, the Commission's report shows that the new lower tax brackets make the system less progressive in nature. The drop to 6.5 percent (7.5 percent on income over 1 million) from 9.55 percent is most significant for higher-income filers earning $75,000 or higher, who pay approximately 93 percent of the State's personal income taxes. While filers earning between $50,000 and $75,000 would get about 14 percent reduced on their taxes, those earning $75,000 and above would benefit the most by getting roughly 30 percent reduction on their taxes.

Business

The most important and controversial aspect of the report is the impact of BNRT and the replacement of the sales and corporate tax. All businesses doing business in the State (including the service sector) would be subject to the BNRT. The potential impact to businesses is complicated and the BNRT would have to be further analyzed on an industry by industry basis to be able to provide a more thorough assessment of its impact. Moving forward, the State will have to weigh the potential negative impact to businesses which ultimately affects local government revenue.

It is noteworthy to mention that there are tax experts who suggest the proposed plan could prove unconstitutional. This is primarily because it applies to out-of-state firms, such as Internet retailers. There are also concerns raised that the State may prevail if such lawsuits are filed, in part because the new tax is not a sales tax; however, the State could owe significant refunds if it loses at the U.S. Supreme Court.

At this time, there is not sufficient information available to estimate the financial impact on the County from the various proposed changes. We understand the State Legislative Analyst's Office is completing their analysis of the Commission's recommendations and will soon release their report. We will provide your Board with a copy and summary of their analysis as soon as it is available.

While the Legislature started holding informational hearings on October 9, 2009, the Commission's recommendations have not been introduced in a legislative vehicle for Assembly or the Senate to consider. This Office will monitor all of the proposed changes as they progress through the Legislature, and will work with the Sacramento advocates, the California State Association of Counties, the Urban County Caucus, and other Statewide organizations to ensure the needs and concerns of local governments are considered.

We will keep your Board apprised of the status of this measure and the impacts on the County via Sacramento Updates.

Please let me know if you have any questions, or your staff may contact Martin Zimmerman at 213.974.1326 or mzimmerman@ceo.lacounty.gov.

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FC:JH:pg

c: All Department Heads

2009-10 – 10-09-09 Commission on the 21st Century Economy (Item No. 32, Agenda of October 13, 2009)